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IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FIRST APPELLATE DISTRICT

DIVISION FOUR

JOSEPH HARB, TRUSTEE et al., Plaintiffs and Appellants, v. FRANCHISE TAX BOARD, Defendant and Respondent.	A109715, A110668 (City & County of San Francisco Super. Ct. No. 302520)

This is an appeal following a trial on remand from this court on the issue of whether Donald W. Marken and Claudine H. Marken (Markens)[1] received certain income from California sources that was taxable pursuant to Revenue and Taxation Code[2] section 17951. On remand, the trial court also considered the Markens' posttrial motion for litigation costs. We granted the parties' request to consolidate the Markens' appeal from both the judgment on remand and the order denying their motion for recovery of litigation costs. The Markens contend that the trial court erred in concluding that income they received from incentive stock options and their pension plan was taxable. They also argue that the court erred in excluding their declarations and that it abused its discretion in denying their motion for litigation costs. We affirm.

[1] Donald W. Marken died in 1999 and trustee Joseph Harb was substituted in this action. For ease of reference, we refer to the parties by their first names.

[2] Unless otherwise indicated, all statutory references are to the California Revenue and Taxation Code.

I. FACTUAL BACKGROUND

The parties stipulated to the following facts: The Markens were married in 1975 and lived in Glenbrook, Nevada, in 1993. During 1993, they were residents of Nevada for California and federal income tax purposes. Donald, however, was an employee of California Compensation Insurance Company (CalComp), a California corporation, for a portion of 1993. For the same period, he also served as president and chief executive officer of Business Insurance Company (BICO), of which CalComp was a wholly owned subsidiary. In April 1993, BICO and CalComp entered in a merger with Foundation Health Corporation. The merger transaction closed in August 1993. Donald's employment with CalComp terminated in 1993 following the sale of BICO's stock to Foundation Health Corporation. Donald owned stock in BICO that he acquired as one of the founders and original investors in the corporation.

The Markens filed a joint California nonresident income tax return for the 1993 calendar year. As nonresidents, the Markens were required to identify on their California income tax return, those items of their income which were California source income. The Markens reported total adjusted gross income of $2,821,578 on their California tax return, and designated only $528,786 as California source income. The $528,786 represented income Donald earned as an employee of CalComp and BICO during 1993. The Markens also realized $625,686 from the sale of BICO incentive stock options. In addition, the Markens reported $22,500 in retirement income, reflecting Donald's distribution received on February 13, 1993, from the profit-sharing plan maintained by the Donald W. Marken Professional Corporation. Finally, the Markens' income included $1,630,682 in net long-term capital gains, dividend income of $6,263, and interest income of $7,661.

In 1996, the Franchise Tax Board (FTB) commenced an examination of the Markens' 1993 California income tax return. It concluded that the Markens were California residents in 1993 and that they were subject to California tax for all of their 1993 taxable income. In April 1998, the FTB assessed the Markens with an additional $244,012 in tax liability. In May 1998, the Markens paid the additional taxes plus

interest for a total payment of $342,491.22. They, in turn, filed a refund claim and demanded the refund of the entire additional income tax liability plus interest.

The FTB did not make a decision on the refund claim within six months. Consequently, the Markens commenced the instant litigation, filing a complaint for a refund of personal income taxes in the trial court. They alleged that with the exception of the $528,726 they reported as California source income, the remainder of their 1993 income was non-California source income. In the first trial of this matter, the court found that the Markens were not California residents and entered judgment for them in the amount of $342,491.22 including interest. On appeal, Division Four of the First District Court of Appeal concluded that the trial court erred in not permitting the FTB to assert as an alternative basis for Markens' tax liability that their income derived from California sources. We remanded the cause to the trial court for resolution of the FTB's California source defense as a basis for the asserted deficiency assessment.

On remand, the trial court concluded that the Markens had additional California source income in the amount of $648,186 and assessed taxes due of $63,105 plus interest of $26,390. Since the Markens had already made a tax payment of $342,491 in May 1998, the court found that they were entitled to a refund in the amount of $252,996 ($342,491-$89,495), plus interest.

The Markens moved for an award of litigation costs pursuant to section 19717. The court denied the motion, finding that the Markens were not the prevailing party in this action because the FTB established that its position concerning the source of certain portions of the Markens' 1993 income was substantially justified. The court also determined that the Markens failed to exhaust all of their administrative remedies prior to filing their complaint in this action.

II. DISCUSSION

The Markens contend that the trial court erred in determining that certain additional income earned in 1993 was California source income and taxable. We affirm the trial court's determination that the income was taxable.

A. BICO Stock

The Markens argue that the trial court erred in determining that the gain they realized from their sale of BICO stock was taxable as ordinary gain as opposed to long-term capital gain. They acknowledge Donald's sale of the BICO stock was taxable as ordinary gain pursuant to Internal Revenue Code section 422, but contend that the gain was not California source income.

In 1994, CalComp issued a Form W-2c (Statement of Corrected Income and Tax Amounts) to Donald, reflecting an increase in his 1993 compensation of $625,686. This amount represented income from the sale of BICO stock that Donald acquired through the exercise of incentive stock options.

Under California's Personal Income Tax Law (§ 17001 et seq.), income resulting from the exercise of a stock option that fails to meet certain holding requirements is subject to taxation pursuant to the Internal Revenue Code provisions governing incentive stock options and disqualifying dispositions. (Rev. & Tax. Code, § 17501; Int.Rev. Code, §§ 421(b), 422.) Specifically, Internal Revenue Code section 422 provides holding requirements to determine whether a transfer of a share of stock pursuant to the exercise of an incentive stock option is taxable as income or long-term capital gain. Under Internal Revenue Code section 422, if the transfer is made within two years from the date the option was granted or within one year after the share was transferred to the taxpayer, it is taxable as income under section 421(b) of the Internal Revenue Code. That section provides that an increase in income attributable to a disqualifying disposition is treated as income for the taxable year in which the disposition occurred. (*Ibid.*)

Here, the Markens do not dispute that they did not meet the holding requirements of Internal Revenue Code section 422 when Donald sold the BICO stock. They argue that the Revenue and Taxation Code lacks provisions comparable to Internal Revenue Code sections 421 and 422. In particular, they assert that there is no statutory provision in California addressing whether the gain from the disqualifying disposition constitutes wages or compensation and, hence, California source income.

Contrary to the Markens' argument, however, the Revenue and Taxation Code specifically provides that disqualifying dispositions are to be treated as income for the taxable year in which the disposition occurred in accordance with the Internal Revenue Code sections 421 and 422. (Rev. & Tax. Code, § 17502; cf. *Daks v. Franchise Tax Bd.* (1999) 73 Cal.App.4th 31, 34 [applying Rev. & Tax. Code, § 17501 and Int.Rev. Code § 401 et seq. to pension plan distributions].) And, there is no question that the income attributable to the disqualifying dispositions constituted wages within the meaning of the Revenue and Taxation Code. California's Personal Income Tax Law provides that gross income is to be determined in accordance with the Internal Revenue Code. (Rev. & Tax. Code, § 17081.) The Internal Revenue Code specifically defines wages as including all remuneration for services performed by an employee for his employer including the cash value of all remuneration paid in any medium other than cash. (Int.Rev. Code, § 3401(a).) Wages, thus, include the income derived by an employee as a result of a disqualifying disposition of an incentive stock option. (*Sun Microsystems, Inc. v. Commissioner* (1995) 69 T.C.M. (CCH) 1884 (*Sun Microsystems*).)[3]

The fact that the Markens were nonresidents does not alter the classification of the income as wages. A nonresident's gross income includes all income from sources within the state. (§ 17951; *Newman v. Franchise Tax Bd.* (1989) 208 Cal.App.3d 972, 977 (*Newman*).) It is undisputed that Donald earned the income as an employee of CalComp, a California corporation. The evidence demonstrated, and the court found, that Donald performed services for CalComp in California.[4] Since a California nonresident

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[3] The amount of compensation is the difference between the fair market value of the shares on the date of the exercise of the option and the amount paid for the shares. (*Sun Microsystems, supra*, 69 T.C.M. (CCH) 1884.)

[4] CalComp acknowledged that the income was California source income by including it in Donald's amended W-2 for 1993. In a letter accompanying the amended W-2, CalComp stated: "Per IRS regulations, when an employee exercises stock options, and the stock is sold by the employee within two years from [the] date of grant of the option, or within one year from [the] date of exercise of the option, CalComp is required to include in the employee[']s W-2 as income, the difference between the exercise price of the option and the value of the stock at the time of sale."

taxpayer's income includes compensation from sources in California, the Markens were subject to California taxation for the income Donald derived from the sale of his incentive stock options.

The Markens further contend that if this court upholds the trial court's finding that the gain from the sale of the BICO stock options was compensation, then we must allocate his total gross income between California and other jurisdictions. They argue that allocation is required because only the portion of Donald's compensation attributable to services performed in California is taxable as California source income.

When a nonresident taxpayer has gross income from sources within California and outside the state, his gross income will be allocated and apportioned between the jurisdictions. (§ 17954; *Newman, supra*, 208 Cal.App.3d at p. 977.) While the Markens might have been able to allocate their income between jurisdictions in which Donald worked in 1993, they failed to do so.[5] In addition, they failed to make a timely claim for a refund on this basis and are foreclosed from raising the claim now. A taxpayer may bring an action for a refund only on the specific grounds set forth in the claim for refund. (*Barclays Bank Internat. Ltd. v. Franchise Tax Bd.* (1992) 10 Cal.App.4th 1742, 1749 [courts are without jurisdiction to consider grounds not set forth in refund claim].)

B. Pension Plan Income

The Markens argue that the trial court erroneously concluded that a $22,500 distribution from a profit-sharing plan was California source income. They assert that the services that were the basis for the right to the pension plan disbursement were not performed in California. As evidence to support their argument, they point to the fact that by signing their 1993 California income tax return under penalty of perjury, they were affirming that the pension plan distribution was not for services that were performed in California.

"In a suit for tax refund, the taxpayer has the burden of proof; he must affirmatively establish the right to a refund of the taxes by a preponderance of the

[5] We note the evidence reflects that in 1993, Donald worked for BICO and CalComp in California.

evidence." (*Consolidated Accessories Corp. v. Franchise Tax Board* (1984) 161 Cal.App.3d 1036, 1039 (*Consolidated Accessories*).) Thus, the Markens had the burden of establishing that the pension plan income was not derived from a California source. (See § 17951.)

Here, the Markens reported $22,500 in pension income on their 1993 federal tax return, but did not report that sum on their California return. The parties stipulated that the $22,500 was distributed to Donald from the Donald R. Marken Professional Corporation, a California corporation. The Markens failed to provide any other evidence of the source of the pension income. Inasmuch as they had the burden of proof on the issue, we uphold the trial court's finding that the income derived from a California source. (*Consolidated Accessories, supra*, 161 Cal.App.3d at p. 1039.)

C. Exclusion of Declarations

The Markens contend that the trial court erred in excluding the declarations of Claudine and Joseph Harb, Donald's accountant.

The declarations were signed on March 31, 2004, and offered evidence concerning where Donald conducted business in 1993, in particular asserting that Donald worked in California "no more than" or "less than" 45 percent of the time. The trial court excluded the declarations, finding that Claudine and Harb "provided testimony at the March 20, 2000 trial, [and] had every opportunity to produce evidence on the issues at that time, these declarations were not subject to cross examination, and portions of their averments lack credibility as they conflict with prior testimony by the witness."

We review a trial court's ruling as to the admissibility of evidence for abuse of discretion. (*People ex rel. Lockyer v. Sun Pacific Farming Co.* (2000) 77 Cal.App.4th 619, 639.) Here, the trial court was presented with new declarations that clearly conflicted with evidence the witnesses had presented in prior testimony concerning the amount of time Donald worked in California and that the court opined lacked credibility. The record supports the trial court's determination to exclude the evidence.

D. Recovery of Litigation Costs

The Markens argue that they are entitled to recover their litigation costs under section 19717, subdivision (c)(2)(A) because they prevailed on 72 percent of the income they reported as non-California source income. The trial court denied the Markens' motion for recovery of litigation costs, finding that they were not the prevailing party as the FTB established that its position concerning the source of certain portions of the Markens' 1993 income was substantially justified within the meaning of section 19717, subdivision (c)(2)(B)(i).[6] The court also found that the Markens failed to exhaust all of their administrative remedies as required by section 19717, subdivision (b)(1).

The trial court did not err on the question of whether the FTB was the prevailing party in the litigation. Section 19717 grants the court in a tax refund action the discretion to award taxpayers their reasonable litigation costs if they prevail and the position of the FTB was " 'not substantially justified.' " (*Lennane v. Franchise Tax Bd.* (1996) 51 Cal.App.4th 1180, 1183.) " 'Substantially justified' is construed to mean 'not necessarily a prevailing position' but one which is ' "justified to a degree that would satisfy a reasonable person" or . . . has a " 'reasonable basis both in law and in fact.' " ' " (*Id.* at pp. 1188-1889.) We review the trial court's determination on this issue for abuse of discretion. (*Id.* at p. 1189.)

Here, the FTB established that it was correct in its determination that the Markens were subject to tax for income deriving from California sources. Indeed, the additional income attributable to California sources amounted to $648,186. On these facts, the FTB's efforts in seeking additional tax for the Markens' California source income were substantially justified. The Markens also argue the FTB was not substantially justified in seeking tax on $1,630,682 in net capital gain that was reported on their 1993 federal tax return. The record, however, supports the FTB's position that it had a viable legal basis for its theory in light of the federal return and the Markens' failure to provide

[6] Section 19717, subdivision (c)(2)(B)(i) provides that "[a] party shall not be treated as the prevailing party in a proceeding to which subdivision (a) applies [prevailing party may be awarded litigation costs] if the State of California establishes that its position in the proceeding was substantially justified."

documentary evidence concerning that income. The trial court, therefore, did not abuse its discretion in denying the Markens' motion for litigation costs.

In light of our disposition, we need not decide whether the Markens failed to exhaust their administrative remedies.

III. DISPOSITION

The judgment is affirmed.

RIVERA, J.

We concur:

RUVOLO, P.J.

SEPULVEDA, J.